CNY: Entering a volatile year

The direction of the Chinese yuan in 2020 will depend on progress in the trade war

USD/CNY movements will continue to depend on the progress of trade agreements, with very little clarity in a US election year.

It is important to keep in mind that the yuan is not a market-based currency and the PBOC will continue to exert control.

Monetary policy will not be relevant for yuan movements.

The key driver of the yuan remains the uncertainty of the trade war

Year-to-date, the yuan has weakened 2.4% against the dollar. The USD/CNY has ranged between 6.6691 and 7.1847, which is a 7.73% difference.

Not only is this range quite large, the change in direction has become increasingly frequent as we approach the final stages of discussions in the so-called phase one deal between China and the US.

Earlier in the year there was optimism in the market that a phase one deal would be reached, however limited in scope. This positive view pushed the yuan to below 7.0 per dollar. But this optimism has not lasted in light of the almost daily news describing how difficult it is for the two sides to reach common ground.

China has requested a rolling back of US tariffs. In early November, it was reported that China wanted the US to lift the tariffs imposed in September, and to offer assurances that it would not implement the remaining tariffs planned for December.

The latest version of China's demands reported in mid-November appears even more forthright. China apparently is asking for a rollback of tariffs to the situation as it stood in May. One can imagine that this would create tremendous hurdles in the US from a political standpoint.

We have not jumped on the optimistic bandwagon, as we believe that even if there were to be a phase one deal, it may not have much substance, may not include any tariff rollbacks, but could include clauses to defer the December tariffs.

Based on this view, our USD/CNY forecast for the end of 2019 is 7.00.

We could be wrong. And there could be a meaningful phase one deal, with some rollback of tariffs signed before year-end. But we assign a small probability to this event.

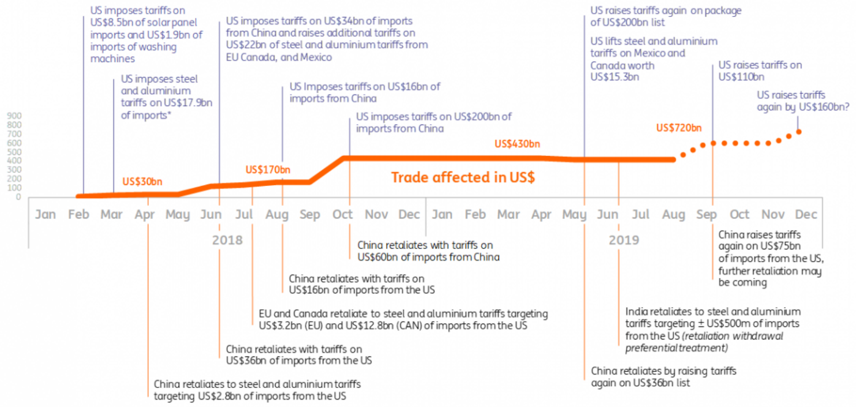
There will be many similar drivers of the yuan in 2020 compared to 2019

We expect the yuan to continue to be trade-talk-driven in 2020. In our 2020 outlook report we discuss the risks and opportunities for the Chinese economy and point out that the trade war is expected to continue.

It is inevitable that the yuan exchange rate will be very volatile. News on the trade talks, including tariffs, tension related to technology companies and tension over international political issues, will impact on any future trade agreements to varying degrees.

High CNY volatility will continue even if there is a phase one deal because the market will then start to question the likelihood of phase two or three deals. The market is likely to remain sceptical on progress of the trade talks after the US Presidential election. It seems likely that trade tensions will persist even if there is a new US president, which is also uncertain.

Fig 45 Trade war timeline



Source: ING

Daily fixing will still be the determinant of the spot rate

The market generally assumes that all currencies are moved by more-or-less the same set of factors. China is an outlier.

We have to keep in mind that the yuan is not a purely market-based currency. Reform of the currency mechanism will be slow for the duration of the trade war in order to avoid unnecessary uncertainty created by any new mechanism.

We expect the daily fixing to continue to be the main guide for USD/CNY. Though we saw deviation of the spot rate from the daily fixings in August and September, the experiment was short-lived. The yuan has returned to a time when fixing is in the driving seat.

There has been considerable speculation that any trade deal between the US and China could include some form of currency manipulation clause. Exactly what this may look like is a subject for the negotiators. But there is a ready-made blue-print in the form of Chapter 33 of the US Mexico Canada (USMCA) Free Trade deal.

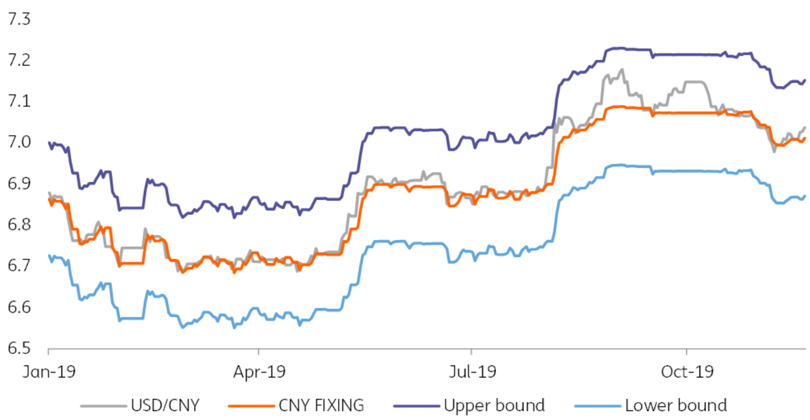
The main elements of such a clause concern the reporting of official interventions in FX markets, including data on FX reserves and positions in forward markets.

The parties involved meet annually to discuss the arrangement and any alleged infringements, and there is scope for parties that believe they have suffered a loss according to the behaviour of the other signatories, to seek financial redress.

Something similar was also agreed in the revamped Free Trade deal with South Korea. And it looks like it may become a "boilerplate" inclusion for any US trade deal.

We remain doubtful that China will want to sign up to a clause like this, which may explain part of the hold up on a phase one deal. China may argue that it already fulfils these obligations by reporting to the IMF, and might refer to their IMF article IV assessment which notes that "China's disclosure of FX intervention data meets international standards since joining IMF's SDDS." Signing up to a bilateral deal on the currency with the US might well be seen by China as an unacceptable loss of sovereignty.

Fig 46 PBOC's USD/CNY fixing, bands and USD/CNY movement



Source: Bloomberg

Portfolio flows

In 2019, one of the factors that has occasionally supported the yuan has been inflows from portfolio investments.

MSCI increased the China A share inclusion factor to 20% in three steps in 2019, with increments of 5% in May, August and November. It is reported that the November increment will draw another US$35-40 billion of funds into the A-share market. FTSE also has included A-shares into its index.

In April 2019, the Bloomberg Barclays Global Aggregate Index started the inclusion of Chinese bonds. As of November data, foreign holdings of yuan bonds reached CNY2 trillion.

We should read these encouraging numbers with care. There could be outflows if there are redemptions of investments from these indices when the market is rocky, which could occur were the trade war to damage the Chinese economy further.

Monetary policy will not be relevant for yuan movements

Monetary policy seldom has a material impact on USD/CNY movements. Take 20 November as an example, where the PBoC cut both the 1-year and 5-year Medium-Lending Facility interest rates by five basis points, but the yuan strengthened during China's trading hours from 7.0336 to 7.0309.

We have commented several times that the yuan does not move with interest rate differentials because arbitraging activities on interest rates are difficult to operate in China – since China's capital account is only half open.

This article is part of our 2020 FX Outlook report.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
USD/CNY	7.03	7.00	7.05	7.00	6.95	6.85
EUR/CNY	7.78	7.70	7.76	7.77	7.78	7.74

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